IN THE

Supreme Court of the United States

OCTOBER TERM, 1941

No. 1196

IN THE MATTER

of

PRUDENCE-BONDS CORPORATION,

Debtor.

IN THE MATTER

of

The Judicial Settlement of the Account of Proceedings of MANUFACTURERS TRUST COMPANY, as Successor Trustee of Prudence-Bonds, Twelfth Series, under Trust Agreement dated February 1, 1928, between Prudence-Bonds Corporation and Chatham Phenix National Bank and Trust Company, as Trustee.

MANUFACTURERS TRUST COMPANY,

Petitioner,

against

CHARLES H. KELBY and CLIFFORD S. KELSEY,
Trustees of the Debtor;
PRUDENCE-BONDS CORPORATION
(New Corporation);
MARY KEANE, et al.;
GEORGE E. EDDY and
PRUDENCE SECURITIES ADVISORY GROUP.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT AND BRIEF IN SUPPORT THEREOF

CHARLES E. HUGHES, JR.,
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Counsel for Petitioner.

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

To the Honorable the Supreme Court of the United States:

Manufacturers Trust Company, Petitioner, prays that a writ of certiorari issue to review the decree (R. 519) of the United States Circuit Court of Appeals for the Second Circuit, made in the above entitled matter on February 24, 1942,

which decree affirmed an order of the United States District Court for the Eastern District of New York, entered September 3, 1941, modifying and revising a report of the Special Master and denying a motion of Manufacturers Trust Company to dismiss objections to its account and for summary judgment approving its account (R. 8-11).

Opinions Below

The opinion of the District Court (R. 500) is not reported.

The opinion of the Circuit Court of Appeals (R. 519) is reported in 125 F. (2d) 650.

The opinion of the Special Master is not reported but is printed in the record (R. 333).

Jurisdiction

The opinion of the Circuit Court of Appeals was rendered February 3, 1942, and the decree and order for the mandate thereon was entered February 24, 1942.

The jurisdiction of this court to review the decision of the Circuit Court of Appeals is invoked under Section 240 (a) of the Judicial Code, as amended by Act of Congress of February 13, 1925 (U. S. Code, Title 28, Section 347).

Questions Presented

1. Whether the Federal court herein has applied New York state decisions governing the standing of security holders to assert claims of the character involved in the objections here presented against corporate fiduciaries.

2. Whether the Federal court herein has applied New York state decisions governing the application of the statute of limitations to claims asserted more than six years after the alleged breaches of trust occurred.

3. Whether the bankruptcy court has jurisdiction over the subject matter of the objections here in question.

Statement

This is a bankruptcy proceeding.

The facts, which are not in dispute in any material respect, are set forth at length in the findings annexed to the Special Master's Report (R. 347-478).

The Debtor, Prudence-Bonds Corporation, and the Guarantor, The Prudence Company, Inc., were organized in 1919 by a common parent. The Debtor was organized under the Business Corporation Law of New York, and the Guarantor, its affiliate, was organized under the Banking Law of that state (R. 347, 452).

Between January 15, 1920 and February 2, 1931 the Debtor entered into eighteen separate but generally similar trust agreements with various corporate trustees, to secure its bonds of different series, including the Twelfth Series here in question (R. 347). In the Twelfth Series, Petitioner was the successor by merger of Chatham Phenix National Bank and Trust Company as trustee (R. 348, 453).

From time to time the Debtor deposited various mortgages, other securities and cash as collateral under the respective trust agreements. Bonds of the different series issuable against the collateral were authenticated from time to time by the various corporate trustees and delivered to the Debtor, which in turn delivered them to the Guarantor for sale to the public with a guarantee of payment of interest when due and of principal within eighteen months after maturity (R. 347-364, 452-453).

The trust agreement, in addition to providing for the deposit of collateral and the issuance of bonds from time to time, reserved to the Debtor extensive powers, characterized by the Special Master as "extraordinary powers" (R. 337), to collect and retain interest on the deposited securities, extend and enforce deposited mortgages in the name of the corporate trustee or otherwise, release portions of the mortgaged premises, collect proceeds of fire insurance, make substitutions of collateral of various classes, collect and remit to the corporate trustee payments of principal on the deposited

mortgages, pay bonds and surrender them for cancellation, and withdraw so-called "excess collateral" arising through such transactions (R. 337, 29-30, 33-37, 50). Under the agreement there was almost total absence of power on the part of the trustee prior to a default (R. 29-36), with the result that, until default, it was, as we submit, in substance no more than a depositary to hold the pledged collateral.

Interest and principal on all the bonds were paid when due, until 1932, when the Guarantor invoked the above-mentioned eighteen-months clause as to payments of principal (R. 364). Under the indenture (R. 50, 23-24), however, there was no event of default until after the expiration of the eighteen-months period. In 1933, due to the regulations promulgated by the New York State Banking Department following the bank holiday, certain defaults occurred in the payment of interest. See *Pres., etc., of Manhattan Co.* v. *Prudence Co.*, 266 N. Y. 202.

On June 29, 1934 the Debtor, and on February 1, 1935, the Guarantor, filed petitions under Section 77B of the Bankruptcy Act (R. 365). Separate plans of reorganization of the Debtor and of each of the eighteen series of bonds were approved and confirmed by the court (R. 370-371) (*In re Prudence Bonds Corporation (Chemical Bank & Trust Co.*, Appellant), 79 F. (2d) 205 (C. C. A. 2)). The so-called general plan of reorganization provided in part for the formation of a new corporation (hereinafter called the "New Corporation") to succeed to the rights of the Debtor, the bondholders receiving voting trust certificates representing its entire capital stock (R. 377). Each of the so-called separate series plans provided for modification of the bonds, and for the appointment of a successor trustee under a modified trust agreement (R. 151, 379-385). It is undisputed that all property then held by the various corporate trustees, including Petitioner, was turned over to the successor trustee (R. 290-292).

By order of April 27, 1938 all of the corporate trustees were directed to file accounts of all of their proceedings as trustees under the various trust agreements (R. 380-384),

and the accounts were filed in August and September 1938 (R. 403).

The jurisdiction of the District Court to settle the accounts of the corporate trustees in respect to transactions prior to the institution of the 77B proceedings was challenged (R. 414-415) by the Prudence Securities Advisory Group, a bondholders committee which had intervened herein and which is hereinafter sometimes referred to as the "Advisory Group". The District Court held that it had no jurisdiction (R. 420-421, 161-162). On appeal the Circuit Court of Appeals reversed (*Central Hanover Bank & Trust Co., et al.* v. *President and Directors of Manhattan Co., et al.*, 105 F. (2d) 130; R. 424).

On October 2, 1939, objections were filed to the accounts in all except one of the eighteen series by the trustees of the Debtor and by the New Corporation, on their own behalf and on behalf of all of the bondholders, and in some of the series by certain bondholders on behalf of themselves and other holders of bonds (R. 427, 439).

In the Twelfth Series here at issue the objections of the trustees of the Debtor and the New Corporation (R. 106-125) were as follows:

1. To allowance of credit for withdrawals by the Debtor of collateral aggregating $826,500 in amount, between October 30, 1930 and November 20, 1931, either as excess collateral or on the substitution of other collateral, at a time when some of the other collateral (one or two mortgages in each instance) was in default in payment of principal for more than sixty days (R. 107-108, 117). Section 6 of Article I of the trust agreement provided that the Debtor, when not in default on its bonds, might (1) withdraw any bond and mortgage from the "Trust Fund" and substitute for such withdrawn security any other bond and mortgage of equal face value, and (2) might withdraw any collateral in the "Trust Fund" to the extent that the principal amount of the trust fund (*face* amount of bonds and mortgages) exceeded the par value of outstanding Prudence-Bonds,

"provided, that if any securities deposited in the Trust Fund enumerated in [certain paragraphs] shall be in default in the payment of principal for more than 60 days the Corporation shall be permitted to withdraw only such securities deposited under said paragraphs * * * as shall be so in default, * * *" (R. 34-35).

2. To allowance of credit for withdrawals by the Debtor of cash aggregating almost $1,000,000 between August 30, 1929 and November 17, 1931, as excess collateral at times when some of the collateral in the trust fund (one or two mortgages in each instance) was in default in payment of principal for more than sixty days (R. 108-109, 118-120).*

3. To allowance of credit for the cancellation of $229,100 principal amount of bonds delivered by the Debtor to the Trustee in lieu of cash collected by the Debtor on account of bonds and mortgages in the trust fund, between September 12, 1932 and January 28, 1933, when certain collateral was in default and when there had been a failure to pay principal of outstanding bonds, although the eighteen-months period was still running (R. 110-112). Section 1(h) of Article III of the trust agreement provided that the Debtor should monthly pay or deliver to the trustee, to be held as part of the "Trust Fund", cash or liquid securities (together with a statement of collections) "equal to the aggregate of all amounts collected or applied on account of principal of any securities in the Trust Fund during the preceding calendar month". It was provided, however, that "The

*As cash accumulated in the trust fund as a result of the amortization of mortgages the Debtor found it necessary to withdraw such cash in order to keep it invested at 6% interest. In order to withdraw the cash the Debtor deposited additional mortgages thus creating sufficient excess collateral to permit the withdrawal of the cash (R. 96, 91, 94, 100-104, see Special Master's Report, R. 456-459). The success of the Debtor's business depended upon its ability to keep cash invested at 6% interest since most of the bonds carried interest at 5½% and the Debtor's and Guarantor's profit had to be derived from the differential of ½ of 1% (R. 100-102, 362). When mortgages were withdrawn they were accompanied by temporary substitutions of other mortgages or cash (R. 107, 93, 96, 91, 94, 99, see R. 457).

Corporation may deliver to the Trustee [for cancellation] in lieu of the payment or delivery of cash or securities or any part thereof required by this paragraph, an equal face principal amount of Prudence-Bonds issued hereunder maturing within six months after the date of such statement" (R. 49-50). The third objection asserted that almost all of the bonds, whose delivery for cancellation was objected to, had matured on February 1, 1932, and not within six months after the respective dates of the statement accompanying their delivery (R. 110).

4. To allowance of credit for the withdrawal of a mortgage of $65,000 on February 27, 1933, against the cancellation of bonds of a like amount which matured February 1, 1932, when other collateral was in default and when there had been a failure to pay principal of outstanding bonds although the eighteen-months period was still running (R. 113-115).

The objections in the Twelfth Series by bondholders, so far as they are specific, were substantially similar to those of Trustees of the Debtor, and the New Corporation (R. 126-131). The Advisory Group adopted and joined in the objections of the trustees of the Debtor and of the New Corporation (R. 132, 439, 456).

In the case of each transaction in which collateral was withdrawn, this collateral was delivered to the Debtor. There is no claim that Petitioner profited, or that it turned over any property of the Debtor to any third party, or that it failed to turn over to its successor trustee any of the property in the trust (R. 107-115; **Vide* p. 461). There is

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*This and similar references are to certain findings of fact contained in the Special Master's Report (R. 452-464). Some of these findings were objected to by objectors (R. 487-495), although there was no conflict with respect to the facts as distinguished from the legal significance to be attributed to such facts. Judge Inch, in modifying the Special Master's Report, "sustained" the "objections and exceptions" of the objectors to such report in a blanket ruling (R. 502). Nevertheless, in an opinion dated August 29, 1941, Judge Inch stated: "It [the court] took the facts as found by the Special Master * * *" (R. 503).

no claim that Petitioner has any property for which it has not accounted (R. 107-115, 290-292; *Vide* 461-464).

All of the transactions objected to took place between August 30, 1929 and February 27, 1933, more than six years before the objections were served and filed (R. 107-113, 336, 460 [item 34]). During the entire period covered by the objections, no event of default on the part of the Debtor had occurred (R. 23-24; *Vide* 460), and the collateral was being serviced by the Guarantor in accordance with the trust agreement (R. 24, 33, 51-52, 306).

On December 6, 1940, Petitioner moved to dismiss the objections and for summary judgment on the grounds: (1) that the objectors had no status to file their objections, and (2) that the objections were barred by the six-year statute of limitations (R. 12-13, 23).

The Special Master, appointed by the District Court (R. 133-137), in his report dated April 17, 1941 (R. 333-346), recommended that Petitioner's motion be granted on the first ground, except with respect to objections filed by bondholders who owned their bonds at the time of the alleged violations of the trust agreement. These he ruled were the only proper parties to object. On the second ground he recommended (R. 344-346) that the motion should be denied for the reason that the twenty-year statute of limitations applied.

The District Court (Judge Inch) held that Petitioner's motion should be denied *in toto* (R. 500-502).

The Circuit Court of Appeals, in affirming the order of the District Court, held that the claims passed to transferees of the bonds, so that a class action could be maintained by some or all of the objectors, and that the recoveries would become part of the trust funds. It also held that no statute of limitations commenced to run until the trustee repudiated the trust to the knowledge of the beneficiaries or invoked the aid of the court to pass its accounts.

Specifications of Errors to be Urged

1. The Circuit Court of Appeals erred in not holding, in accordance with the law of the State of New York, that the

claims involved belong only to individual bondholders who held their bonds at the time of the alleged breaches of trust and were not transferred with the bonds. The objections of the trustees of the Debtor, the New Corporation, the Advisory Group and individual bondholders in so far as they purport to act for all bondholders as a class, should have been dismissed.

2. The Circuit Court of Appeals erred in not holding, in accordance with the law of the State of New York, that the six-year statute of limitations is applicable and bars the claims in question.

3. The Circuit Court of Appeals erred in permitting the bankruptcy court to assume jurisdiction over the subject matter of the objections here in question.

Reasons for Granting the Writ

The conflict which we assert between the decisions of the New York state courts and that of the Circuit Court of Appeals herein will be developed fully in the argument contained in the brief filed with this petition. Such a conflict with respect to questions of the large and general importance of those here involved is not in the public interest, which requires that the questions be finally resolved at the earliest possible time. This court has in numerous instances, and in cases of far less general importance, granted certiorari to review decisions of circuit courts of appeals which appear to be in conflict with applicable state court decisions. *City Company of New York, Inc.* v. *Stern*, 312 U. S. 666; *Chase Securities Corp.* v. *Vogel*, 312 U. S. 666; *Vandenbark* v. *Owens-Illinois Glass Co.*, 311 U. S. 538; *West, et al.* v. *American Telephone and Telegraph Co.*, 311 U. S. 223; *Fidelity Union Trust Co.* v. *Field*, 311 U. S. 169; *Six Companies* v. *Highway Dist.*, 311 U. S. 180.

The surcharge sought in the Twelfth Series, here at bar, alone is approximately $2,000,000 (R. 107-115). The aggre-

gate principal and accrued interest of the eighteen series was approximately $61,000,000 (R. 334, 369). The future proceedings in nearly all of them will be directly affected by the decision in the case at bar. There are approximately 83,000 bonds in the eighteen series, held by approximately 30,000 holders (R. 368). Moreover, this Court may take judicial notice of the fact that there are billions of dollars of bonds issued and outstanding in the hands of the public under indentures with New York corporate trustees. If we are correct in our assertion that the decision below is inconsistent with the law of the New York state courts, the rights of bondholders and the nature of the liability of corporate trustees with respect to matters of the type here in issue depends, at the present time, and until the questions here presented are finally resolved will depend, entirely upon whether action is brought in the state courts of New York or in the Federal Court.

We submit that certiorari should be granted at this stage of the proceedings in this matter, despite the fact that the decree of the Circuit Court of Appeals here sought to be reviewed is of an interlocutory character. See *U. S.* v. *Socony-Vacuum Oil Co.*, 310 U. S. 150; *Forsyth* v. *Hammond*, 166 U. S. 506; *The Prudence Co. Inc.* v. *Fidelity & Deposit Company of Maryland, et al.*, 297 U. S. 198; *Spiller* v. *Atchison, T. & S. F. Ry. Co.*, 253 U. S. 117; *United States* v. *Gulf Ref. Co.*, 268 U. S. 542; *Stringfellow* v. *Atl. Coast Line*, 290 U. S. 322; *Denver* v. *New York Trust Co.*, 229 U. S. 123.

The sustaining of any one of Petitioner's contentions will finally and completely dispose of all further proceedings. To require lengthy, complicated and expensive accountings, which will add nothing bearing on the fundamental points of law now fully presented and which will be utterly fruitless if Petitioner eventually prevails on any one of them, and to require that these proceedings be reviewed by the District Court and then by the United States Circuit Court of Appeals before they can be presented to this Court for adjudication, is wasteful and undesirable. Moreover, if jurisdiction is lacking, numerous practical problems with respect to further proceedings held before a court without jurisdiction,